



WASHINGTON STATE LEGISLATURE  
**Office of the State Actuary**

March 15, 2005

TO: Steve Nelsen, Executive Director  
LEOFF 2 Retirement Board

FROM: Marty McCaulay, Associate Actuary  
Office of the State Actuary

CC: Matt Smith, State Actuary  
Office of the State Actuary

**RE: PROPOSED CHANGES TO OPTIONAL REDUCTION FACTORS  
POST-RETIREMENT**

This memo will present the results of pricing the proposed ad hoc update to the optional reduction factors for annuitants whose original benefits began before September 30, 2002.

**Members Impacted**

Of the 316 annuitants in pay status as of September 30, 2003, we found 108 who had retirement dates earlier than September 30, 2002, had a reduction for a joint and survivor payment option, had a reduction for retiring before the plan's normal retirement age, or had reductions for both. Of those 108 members, we found that 103 members' retirement benefits would be increased by replacing these factors with the current factors from the Washington Administrative Code (WAC). As a result, annual benefits would increase \$152,976. The details of the annual benefit increase are shown below:

|            |                           | Normal<br>Retirement<br>with Joint and<br>Survivor<br>Annuity | Early<br>Retirement<br>with Life<br>Annuity | Early<br>Retirement<br>with Joint and<br>Survivor<br>Annuity | All         |
|------------|---------------------------|---|---|--|-------------|
| <b>Sum</b> | Number Impacted           | 77  | 10  | 16   | 103         |
|            | Annual Benefit            | \$1,025,523   | \$117,878                                   | \$237,155  | \$1,380,555 |
|            | Updated Annual<br>Benefit | \$1,132,176   | \$125,636                                   | \$275,719  | \$1,533,532 |
|            | Annual Increase           | \$106,653   | \$7,759                                     | \$38,564   | \$152,976   |

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|                |                           | <b>Normal<br/>Retirement<br/>with Joint and<br/>Survivor<br/>Annuity</b> | <b>Early<br/>Retirement<br/>with Life<br/>Annuity</b> | <b>Early<br/>Retirement<br/>with Joint and<br/>Survivor<br/>Annuity</b> | <b>All</b> |
|----------------|---------------------------|--|---|---|------------|
| <b>Average</b> | Annual Benefit            | \$13,318   | \$11,788  | \$14,822  | \$13,403   |
|                | Updated Annual<br>Benefit | \$14,704   | \$12,564  | \$17,232  | \$14,889   |
|                | Annual Increase           | \$1,385  | \$776   | \$2,410   | \$1,485    |
|                | Percentage Increase       | 10.40%   | 6.58%   | 16.26%  | 11.08%     |

### Costs

Overall, this proposed post-retirement benefit adjustment would create a fully projected liability increase and a credited projected liability increase for LEOFF 2 of about \$2 million and a total contribution rate increase of 0.02%. Of that increase, 0.01% would be charged to the local employer and the member rate increase would be 0.01%. The resulting fiscal impact would be as follows, based on an assumed effective date of the rate increase of September 1, 2005:

| <b>LEOFF 2</b>          |              |              |              |
|-------------------------|--------------|--------------|--------------|
| <b>(\$ in millions)</b> | <b>05-07</b> | <b>07-09</b> | <b>05-30</b> |
| State                   | \$0.0        | \$0.0        | \$0.0        |
| Local Employer          | \$0.2        | \$0.2        | \$2.1        |
| Employee                | \$0.2        | \$0.2        | \$2.1        |

### Assumptions

We assumed that this would be a one-time increase that would only apply to members in pay status with benefit commencement dates before September 2002. We assumed that it would only apply to joint and survivor annuitants and to early retirements. We assumed that only upward adjustments would be made. We assumed that beneficiaries and disabled annuitants would be treated the same as service retirees. We assumed that affected annuitants would not be required to make additional contributions based on rates that would have been in effect if the updated assumptions had been in effect while they were actively employed under the system. We assumed that future changes in factors would not result in future benefit adjustments. We also assumed this increase would not take effect until September 2005 at the earliest, with no retroactive application, so we subtracted the present value of two years' benefit increases from the liability determined at September 30, 2003.

## **Other Considerations**

It is an industry-wide standard of practice to periodically update administrative factors for changes in actuarial experience or actuarial assumptions. If experience differs from the assumptions, and the underlying assumptions remain unchanged, long-term actuarial gains and losses can occur. Thus, assumptions must be periodically adjusted to assure that LEOFF 2 is neither over-funded nor under-funded.

Questions concerning administration in this area should not be reviewed in isolation of the plan's funding policy. The current administrative practice of applying updated reduction factors for optional forms of payment only to retirees who retire after the effective date of the updated factors is consistent with industry-wide standards of practice and consistent with current LEOFF 2 funding policy. This current policy attempts to systematically and fully fund members' benefits over their working lifetimes with member contributions and tax revenues supported by the generation of taxpayers receiving the benefit of the members' services.

The practice of providing post-retirement benefit increases for the exclusive benefit of existing and future retirees only when administrative factors are updated in the member's favor would result in the systematic ratcheting up of future plan liabilities. This could lead to systematic under-funding or could require systematically increasing contribution rates in the future. Current and future members, as well as current and future generations of taxpayers, would assume this cost and disproportionate transfer of risks.

It is also worth noting that assumptions other than mortality will impact reduction factors for optional forms of payment. For example, a future change in the assumed rate of investment return is very likely. A reduction in the assumed rate of investment return would increase the actuarial reduction required to provide post-retirement survivor benefits. Under current administrative practices, existing retirement benefits for retirees currently in pay status would not be reduced to reflect this type of actuarial assumption change.

The administration of benefits in this area is complicated, technical and linked to the plan sponsor's funding policy. Changes in this area of administration should not be reviewed in isolation of the plan's funding policy and plan sponsors should proceed cautiously when considering changes in this area.